# 2022 Capital Markets Outlook (First of a series)

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*In our 2022 Capital Markets Outlook, we discussed expectations for the year ahead. Topics included covenant-lite loans, inflation and rising interest rates, the LIBOR/SOFR transition, the heightened prevalence of unitranche loans and the continued focus on ESG.*

*Kelli Marti, Churchill's head of CLO management, and Jessica Nels, capital markets, begin a series of market commentaries on the Outlook:*

Historically, covenant-lite was not a topic for much conversation in the middle market, as these loans were seen mostly in the broadly syndicated market. As the market evolved competition intensified and lines blurred between public and private credit. Cov-lite increasingly gained share among smaller, unrated loans. What prompted this change? We observed:

- Larger sponsors eager to put capital to work are coming down-market and demanding large market terms from their club lenders;
- Increased competition among lenders resulting in willingness to differentiate with looser terms;
- Middle market borrowers using large DDTLs to grow through acquisitions, propelling those borrowers into a lender spectrum more willing to provide cov-lite solutions;
- Increase in direct lender capacity leading to smaller lender groups, all members required to accept issuer-friendly terms such as cov-lite;
- Proliferation of the unitranche, with mega-tranches stealing share from the syndicated market; and thus adopting or bridging the gap on their terms.

Our content partners at S&P/LCD, in their 4Q21 Middle Market Review, reported "private loans are increasingly resembling syndicated loans, particularly larger ones that may have been placed in the broadly syndicated market. Pressure has intensified to remove covenants from private loans, with some lenders caving into market demands to forgo the protections even on smaller loans to midsized borrowers, according to market sources."

Similarly per a Fitch report in December, 2021, "As of October 2021, 54% of syndicated middle market loans were covenant-lite." Middle market CLO indentures generally provide a 15% basket for cov-lite transactions, which allows CLO managers to invest frequently in these transactions.

Covenant-lite worked its way down into the upper middle market and to issuers below $50 million in EBITDA. For 4Q21 nearly $25 billion in cov-lite unitranche loans were issued in the large corporate and middle market segments, compared to about $1 billion in 1Q21. Traditionally only the best and brightest broadly syndicated credits garnered covenant-lite status. Today 90% of that market is cov-lite. Theoretically direct lenders offer cov-lite to only the strongest performing middle market credits.

Looking ahead to 2022, lenders highlight lack of discipline around covenants and cov-lite incurrence as areas of concern, per Refinitiv LPC. More than half of lenders said they will not do cov-lite compared to 36% in 4Q21. One-third say they will provide incurrence-only tests for borrowers with more than $40 million EBITDA, down from 41% in 4Q21.

While the ability to trade in and out of BSL financings has made cov-lite palatable for liquid loan managers, that benefit is not available in the middle market. But the prevalence of such terms there will be a key indicator for how issuer-friendly private credit becomes this year.